

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE EASTERN DISTRICT OF TENNESSEE

In re

MOLLY LOUISE RHEA,

Debtor.

No. 96-21146
Chapter 13

MEMORANDUM AND ORDER

APPEARANCES:

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MARCIA PHILLIPS PARSONS
UNITED STATES BANKRUPTCY JUDGE

This case is before the court on the Objection to Confirmation of Chapter 13 Plan filed by Pioneer Credit Company ("Pioneer") on June 19, 1996. Pioneer contends that it has a second priority deed of trust on the debtor's residential real property securing an indebtedness of \$3,609.98, and that Superior Financial Services, Inc. ("Superior Financial") has a third priority deed of trust on that property. Because Superior Financial contends that its deed of trust has priority over Pioneer's deed of trust, these parties have submitted this legal issue to the court. For the reasons set forth below, the court concludes that Superior Financial's interest in the debtor's real property has priority over that of Pioneer's. The following constitutes the court's findings of facts and conclusions of law pursuant to Fed. R. Civ. P. 52(a), as incorporated by Fed. R. Bankr. P. 7052. This is a core proceeding. 28 U.S.C. § 157(b)(2)(K).

I.

The following facts and referenced documents have been stipulated by the parties. By warranty deed dated February 26, 1991, the debtor acquired certain residential real property located in Greene County, Tennessee. On March 23, 1995, the debtor conveyed that property in trust to secure a promissory

note executed that same date in favor of Jefferson Federal Saving and Loan Association ("Jefferson Federal") in the principal amount of \$40,237.60. That first deed of trust to Jefferson Federal was properly recorded with the Register's office for Greene County, Tennessee on March 27, 1995. There is no dispute that Jefferson Federal's deed of trust has first priority.

On May 10, 1995, the debtor obtained a loan from Superior Financial in the principal amount of \$7,793.77. The promissory note executed by the debtor in favor of Superior Financial was to be repaid at an annual interest rate of 28.76 percent in 37 monthly installments of \$320.00, with the last payment being due in June 1998. As security for the repayment of that loan, the debtor executed a second deed of trust to Superior Financial on that same date. That second deed of trust on the debtor's residential real property was thereafter recorded in the Register's office for Greene County on June 12, 1995.

On October 31, 1995, the debtor obtained a loan from Pioneer in the principal amount of \$3,914.74. To secure the repayment of the promissory note to Pioneer, the debtor granted Pioneer a security interest in certain personal property and also conveyed her residential real property in trust to Pioneer. That third deed of trust was recorded in the Register's office for Greene

County on October 31, 1995.

On December 5, 1995, the debtor obtained another loan from Superior Financial as evidenced by a promissory note in the principal amount of \$8,964.52. That note indicates that \$1,507.13 in new proceeds were provided to the debtor and that \$6,616.35 in proceeds were used to pay off the debtor's prior account with Superior Financial, that being the indebtedness evidenced by the promissory note dated May 10, 1995, which was secured by the second deed of trust. The remaining proceeds were applied to insurance and recording fees. Again, to secure this promissory note, the debtor conveyed her residential real property in trust to Superior Financial by deed of trust dated December 27, 1995. That fourth deed of trust was recorded in the Register's office for Greene County on December 28, 1995. None of the four deeds of trust have been released of record.

II.

The debtor filed the petition initiating this case on May 29, 1996. Superior Financial asserts that notwithstanding the payoff of the May 10 promissory note, its position is still prior in right to that of Pioneer because the deed of trust securing the May 10 note contains a "dragnet/cross-collateralization clause" which secures future advances,

including the subsequent loan of December 1995, which it contends was a "optional advance."

Pioneer takes the position that the promissory note referenced in the May 10 deed of trust to Superior Financial was paid off upon execution of the second promissory note to Superior Financial in December 1995, and that the "dragnet/cross-collateralization clause" only secures future debts which are otherwise unsecured or that it only cross-collateralizes different loans made at the same or different times when a balance is left owing on each loan. Both parties argue the applicability of TENN. CODE ANN. § 47-28-103, which addresses the priority of advances under open-end mortgages or mortgages securing future advances.

Future advance clauses and dragnet clauses have long been recognized and enforced by Tennessee courts according to their terms. See *Willie v. First American National Bank (In re Willie)*, 157 B.R. 623, 625-26 (Bankr. M.D. Tenn. 1993); *Rogers v. First Tennessee Bank, N.A.*, 738 S.W.2d 635, 636-37 (Tenn. App. 1987); *Duncan v. Claiborne County Bank*, 705 S.W.2d 663, 664-65 (Tenn. App. 1985). In 1983, the Tennessee legislature endorsed the use of cross-collateralization clauses and future advance clauses in debt instruments by the enactment of TENN. CODE ANN. § 47-50-112(b), which provides the following:

Any contract, security agreement, note, deed of trust, or other security instrument, in writing and signed or endorsed by the party to be bound, that provides that the security interest granted therein also secures other indebtedness, be it unsecured, commercial, credit card, or consumer indebtedness, shall be deemed to evidence the true intentions of the parties, and shall be enforced as written; provided, that nothing herein shall limit the right of any party to contest the agreement on the basis that it was procured by fraud or limit the right of any party to assert any other rights or defense provided by common law or statutory law in regard to contracts.

See In re Willie, 157 B.R. at 625.

Similar authorizing language is codified in Tennessee's adoption of the Uniform Commercial Code, which at TENN. CODE ANN. § 47-28-102 states:

A mortgage may provide that it secures not only existing indebtedness or advances made contemporaneously with the execution thereof, but also future advances, whether obligatory, or optional, or both, and whether made under open-end credit agreements or otherwise, to the same extent as if such future advances were made contemporaneously with the execution of the mortgage, even though no advance is made at the time of the execution of the mortgage and even though no indebtedness is outstanding at the time any advance is made.

The deed of trust executed by the debtor on May 10, 1995, provides in pertinent part that "this conveyance is made in trust to secure the payment of an indebtedness due Lender to wit:" and thereafter, the following language is typed in:

We are justly indebted to Superior Financial Services, 1190 East Andrew Johnson Highway, Greeneville, Tennessee, in the principal sum of Eleven Thousand

Eight Hundred Forty and 00/100 (\$11,840.00) Dollars as evidence by our promissory note in the same amount of Eleven Thousand Eight Hundred Forty and 00/100 (\$11,840.00) Dollars, of even date herewith signed by us and payable in Thirty-Seven (37) monthly payments of Three Hundred Twenty and 00/100 (\$320.00) Dollars each with the first payment being due one month from date and each month thereafter u[n]til paid in full. The right to make prepayments is reserved.

This instrument is executed for the purpose of securing and making certain the payment of said indebtedness and any renewals of extensions [sic] which may be granted in whole or in part together with court costs and attorney's fee should said note be sued upon for collection.

After the typed-in language, the boilerplate provisions resume as follows:

until said indebtedness is paid in full, and shall secure all extensions, renewals, modifications and changes in form of said indebtedness and the note evidencing same. The terms of said note are incorporated hereby by reference as fully as if copied herein verbatim.

This conveyance shall also secure the payment of any other indebtedness presently existing or hereafter arising, of any type or kind, direct or contingent, owed or to be owed by Borrower (or any one of the Borrowers) to Lender; and this deed of trust shall remain in full force and effect until all obligations secured hereby are fully paid.

Under the section titled "ADDITIONAL COVENANTS AND WARRANTIES," the following provisions are contained:

Borrower further covenants, warrants, and agrees as follows:

1. [t]o also pay, or cause to be paid, the debt hereby otherwise secured, present or future, according to the tenor and effect thereof.

2. All payments received by Lender shall be applied, first, to interest payable on the note and on future advances, if any, and last to the principal of the note and to the principal of future advances, if any.

....

12. When all obligations under this deed of trust and the note and notes secured hereby have been discharged in full, Lender shall deliver to Borrower a legally sufficient release of the lien of this deed of trust at Borrower's expense, together with said note or notes duly canceled.

The courts must determine and effectuate the intention of the parties to a deed of trust as expressed in the four corners of the document. *Rogers*, 738 S.W.2d at 637. The unambiguous language in Superior Financial's May 10 deed of trust provides that it secures not only the promissory note of May 10, 1995, but also "all extensions, renewals, modifications and changes in form of said indebtedness and the note evidencing same" as well as "any other indebtedness presently existing or hereafter arising, of any type or kind, direct or contingent, owed or to be owed by Borrower (or any one of the Borrowers) to Lender; and this deed of trust shall remain in full force and effect until all obligations secured hereby are fully paid." The subsequent promissory note executed by the debtor in favor of Superior Financial in December 1995 is in part a renewal and modification of the debtor's original indebtedness to Superior Financial and

in part, an extension or future advance of additional funds. There is no question that as between the debtor and Superior Financial, the entire indebtedness owed at the time of the bankruptcy filing was secured by the deed of trust executed on May 10, 1995.

Pioneer's argument that the promissory note referenced in the May 10 deed of trust to Superior Financial was paid off upon execution of the second promissory note does not change this fact, even if true.¹ While the original note may have been "paid off" in the December transaction, that does not alter the fact that the original indebtedness was not satisfied, but only renewed and modified. See *Shutze v. Credithrift of America, Inc.*, 607 So.2d 55, 59-60 (Miss. 1992)("[t]he 1985 renewal no doubt 'paid' the earlier note in a formalistic sense, but it was hardly 'full payment' within the language of the deed of trust").

Furthermore, the deed of trust specifically provides that

¹The stipulations of the parties do not address whether it was the intent of the parties in executing the December 1995 note to extinguish or novate the earlier May 10 note, or to simply renew it, along with the new advances. A renewal of a promissory note does not operate as a discharge of the note which it renews unless all of the parties to the original note mutually agree that it is to have such an effect. See *Commerce Union Bank v. Burger-In-A-Pouch, Inc.*, 657 S.W.2d 88, 90 (Tenn. 1983).

it "shall remain in full force and effect until all obligations secured hereby are fully paid." Clearly, one of the obligations secured by the deed of trust is future advances. The Tennessee Code expressly authorizes and contemplates that a deed of trust may secure future advances even when the original indebtedness is no longer owing at the time the future advance is made. TENN. CODE ANN. § 47-28-102, as quoted above, states that "a mortgage may provide that it secures not only existing indebtedness or advances made contemporaneously with the execution thereof, but also future advances, ... as if such future advances were made contemporaneously with the execution of the mortgage, ... even though no indebtedness is outstanding at the time any advance is made."²

The question of the priority of the additional advance to the debtor in December 1995 by Superior Financial is a matter of statutory law. TENN. CODE ANN. § 47-28-101(c) provides that:

Optional advances made under any mortgage securing future advances, other than an open-ended mortgage, are superior in priority to any intervening conveyance

²It could be argued that, in a technical sense, the debtor's December 5, 1995 debt was incurred before her May 10, 1995 note was paid. On December 5, 1995, Superior Financial loaned the debtor \$8,964.52. She then used \$6,616.35 of this loan to pay the outstanding balance on the May 10 note. Thus, the debtor's December 5 debt was a "future advance" secured by the May 10 deed of trust because it was formally and legally incurred before the May 10 note was paid. See *Credithrift*, 607 So.2d at 60 n.3.

or encumbrance unless the mortgagee has actual notice of the intervening conveyance or encumbrance prior to exercising the mortgagee's option to make the advance. For the purpose of this subsection, "actual notice" means knowledge in fact from any source by any means.

The parties have stipulated that Pioneer did not "inform or transmit information to any representative of Superior that a loan was being made to debtor secured by the same property referred to in Superior's Deed of Trust."

Pioneer states that the burden is upon Superior Financial to come forward with proof that it had no actual knowledge of Pioneer's intervening deed of trust in order to have priority. To the contrary, it is Pioneer's burden to establish that Superior Financial had actual knowledge of Pioneer's intervening deed of trust in order for its deed of trust to have priority over the May 10 deed of trust executed by the debtor in favor of Superior Financial. See, e.g., *La Cholla Group, Inc. v. Timm*, 844 P.2d 657 (Ariz. App. 1992), *rehearing denied* (1993), (second mortgagee's failure to establish that first mortgagee had actual knowledge of second mortgagee's intervening lien caused the first mortgagee's future advance to have priority). Pioneer had both the incentive and ability to perform a title search prior to extending its loan and was put on constructive notice of the recordation of Superior Financial's May 10 deed of trust. Had Pioneer provided actual notice to Superior Financial that it was

recording a deed of trust on the same property, the additional advance to the debtor in December 1985 would have been subordinate to Pioneer's deed of trust.

Constructive notice as provided by recordation of Pioneer's deed of trust does not constitute actual notice to Superior Financial. *Blevins v. Johnson County*, 746 S.W.2d 678, 682-83 (Tenn. 1988); *Texas Co. v. Aycock*, 190 Tenn. 16, 26-28, 227 S.W.2d 41, 45-46 (Tenn. 1950). Accordingly, the court finds that Pioneer has failed to establish that Superior Financial had actual notice of Pioneer's intervening deed of trust as defined by TENN. CODE ANN. § 47-28-103(c).

Finally, the court must reject Pioneer's argument that the "dragnet/cross-collateralization clause" only secures future debts which are otherwise unsecured or that it only cross-collateralizes different loans made at the same or different times when a balance is left owing on each loan. Dragnet clauses are enforced by reference to their language and the law. *See, e.g., Credithrift*, 607 So.2d at 59. The dragnet clause within the May 10 deed of trust executed in favor of Superior Financial is not limited to securing only future unsecured debts. Moreover, TENN. CODE ANN. § 47-50-112 clearly provides that a dragnet clause securing future indebtedness is to be enforced "regardless of the class of other indebtedness, be it unsecured"

or not. And as for the remaining argument, the court has already addressed and found not determinative the question of whether a balance was owing at the time of the future advance.

III.

For the reasons stated, the court overrules Pioneer's objection to confirmation filed on June 19, 1996, to the extent stated herein, finding that Superior Financial has a second priority deed of trust on the debtor's residential real property.

SO ORDERED.

FILED AND ENTERED: August 19, 1996

BY THE COURT

MARCIA PHILLIPS PARSONS
UNITED STATES BANKRUPTCY JUDGE